MANUFACTURERS HANOVER

Economic Report

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Commentary on Pertinent Economic Issues

On The One Hand...

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If the questions I've been getting lately are any guide, the issue no longer is are we in a recession, but rather, how bad will it be, and when will it end? In this regard, the statistics are mixed; some suggest a moderate downturn, while others seem to point to a more serious decline. And then there is that elusive, hard-to-quantify element called psychology. Already battered by the events in the Middle East, and by the turmoil surrounding Washington's latest deficit reduction agreement, confidence levels have plunged in response to widespread declines in employment. Indeed, to many businessmen and consumers who are experiencing this downturn for the first time in their adult memory, it looks like the end of Western Civilization as we know it.

Having warned readers more than three years ago (Economic Report—July 1987) that a recession was looming, recent events should come as no surprise. Indeed, as was pointed out in the previous issue of this Report, today's recession—the ninth of the postwar era—had its origins in the stock market crash of October 1987, and its impact on attitudes, wealth, and real estate. Those who heeded these warnings might have missed making the last few dollars in profits—but are undoubtedly better prepared to weather today's economic storm because they didn't overexpand, overhire, overbuy, or overborrow.

Of course, this is small consolation for those who, for one reason or another, got caught up in the current maelstrom and are wondering what comes next. Because this downturn has only recently been recognized, and because it follows in the wake of such developments as a record peacetime expansion, soaring public and private debt, two oil shocks in five years, and an increasingly fragile banking system, it is too soon to determine whether this recession will be mild, average, or deep. What I thought might be useful, however, would be to list the case for a mild versus a deep recession so that readers might have some basis for planning ahead:

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MILD	DEEP
Better inventory management will minimize downtime as producers adjust to slumping sales. Business has been expecting this recession for several years, use of computers to track goods is widespread, as is "just-in-time" controls.	*Inventories don't usually become a problem until after a recession has begun, so current policies and trends offer little guidance for the future.*
Homebuilding has been sliding for the past five years, and must be near rock-bottom. The drop in home prices should soon attract buyers.	*The drop in home prices has affected wealth and confidence to a greater extent than any stock market plunge. What is more, this has left such lenders as banks, insurance companies and pension funds with real estate holdings that are depreciating, thus constraining their ability to make new loans. Finally, the U.S. real estate slump seems to be spreading to other countries, and the corresponding glut of empty buildings will delay the revival in construction spending that usually helps pull the economy out of recession.*

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MILD	DEEP
Speaking of other countries, the lower-valued dollar should help cushion this decline by spurring exports.	*Exports are too small a share of our gross national product to help very much. Furthermore, the drop in the dollar's value has discouraged foreigners from investing in our financial markets, as well as in our companies. They're also turned off by lack of confidence in our economy and in our government, and are increasingly attracted by higher rates back home.*
We entered this recession with much less inflation than we had going into the last two major slumps, so the Federal Reserve should be able to ease sooner and more forcefully to help end it.	*Some Fed members remain concerned over inflation, even though it's largely food and energy, believing that to ease now would be to allow these pressures to spread throughout the economy. They are also concerned about the inflationary implications of the weak dollar. Additionally, lower interest rates might make it easier to borrow—but they will also reduce interest income, on which many households rely.*
At any rate, monetary policy has already eased well before this recession has begun, witness how low our inflation-adjusted interest rates are compared with other industrialized countries. The yield curve is positive, too.	*The yield curve was negative during all of 1989, as the Fed drained reserves from the banking system by the largest amount in postwar history, suggesting that the damage has already been done. Most people are so burdened with debt they might not want to borrow. And the banks, besides lacking sufficient loanable funds, are being increasingly prevented from fulfilling their traditional functions as lenders of last resort by their regulators, who are pressing them to increase their capital ratios, while discouraging them from making certain kinds of loans.*
Small businesses, which were responsible for all of the jobs created in the 1980s and then some, are less likely to be affected by the recession than larger companies.	*But this was precisely because they were able to borrow from the banks; now, many are being denied credit.*
There's plenty of stimulus left in Washington's budget—deficit agreement notwithstanding. First of all, the deficit currently is rising, not falling. Secondly, the announced "cut" of $40 billion for the current fiscal year is less than one percent of GNP—nowhere near the dose of restraint enacted under the Administration of Herbert Hoover, for example. In addition, there'll be less of a drop in defense spending than was scheduled earlier because of events in the Middle East. And there's plenty of public works expenditures still in the pipeline, such as for repairing and rebuilding the nation's infrastructure.	*The fact of the matter is that fiscal policy is not being loosened, as it used to, when it became apparent that a recession had struck. Rather, it is being tightened, and that swing alone will make a difference. Furthermore, the Federal government accounts for 25 percent of the economy today versus only three percent in the 1930s, so any belt-tightening move by Washington is bound to have a greater effect.*

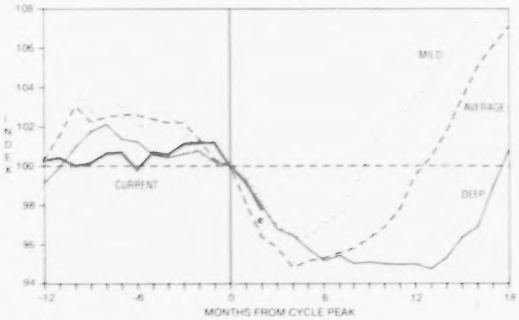
MILD

Most households have more than one person working—and there are many instances where one or more of these family members holds at least two jobs, so the impact of any forseeable rise in unemployment is likely to be less severe than in past recessions. In addition, most people work in the service sector, which is less likely to be affected by a downturn.

DEEP

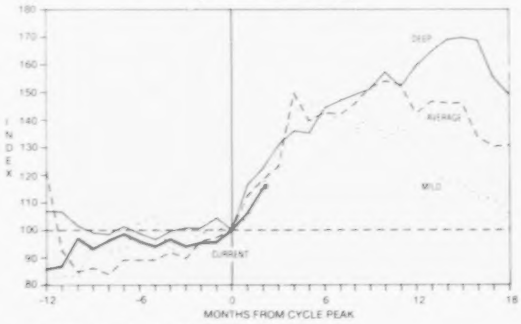
This recession has so far seen unusually large numbers of managerial, professional, technical and clerical support personnel lose their jobs, compared with past declines in economic activity. The crash of 1987 caused many Wall Streeters to lose their jobs. Financial industry employment was also affected by cuts in bank payrolls, while investment bankers lost their positions as the junk bond market contracted. The earlier spate of leveraged buyouts caused many companies to trim staffs, while the slump in real estate is taking its toll among a broad range of white-collar people, from architects, to interior designers, to construction personnel, to brokers.

CHART I
LEADING INDICATORS:
CURRENT EXPERIENCE VS. PREVIOUS 8 CYCLES
(CYCLE PEAK = 100)



Sources: Commerce Department; MH

CHART II
INITIAL UNEMPLOYMENT INSURANCE CLAIMS:
CURRENT EXPERIENCE VS. PREVIOUS 8 CYCLES
(CYCLE PEAK = 100)



Sources: Commerce Department; MH

As you can see, there are good arguments for either extreme. Of course, time will tell which path the economy will take. For the moment, based on a careful perusal of the statistics, and on the assumption that the economy peaked in August, a recession of roughly average dimensions appears to be shaping up (see charts). Since the average recession has lasted about a year, it could mean that bottom will be plumbed by next summer, and that growth will resume well before yearend. If and as this becomes recognized by the public at large, confidence will return and spending will increase.

To ensure this outcome, the monetary authorities should ease significantly; interest rates should be slashed by a point or more, bank reserves should be pumped up, and the regulators should back away and encourage the banks to lend money again. For his part, President Bush needs to convince the American people that he is in control of the situation, and will take steps to alleviate it. He must, however, avoid, such Hooverisms as "prosperity is just around the corner," since people didn't believe it then, and they won't believe it now.

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